In the Supreme Court of the United States

OCTOBER TERM, 1941

NO. . . . . .

H. H. WEGENER,
Petitioner,

VERSUS

GUY T. HELVERING, Commissioner
of Internal Revenue,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF IN SUPPORT OF PETITION

I.

OPINIONS IN COURTS BELOW

This case originated in the United States Board of Tax Appeals. From a decision of the Board adverse to petitioner he took the case for review to the Circuit Court of Appeals for the Fifth Circuit. That Court affirmed the Board. The opinion of the Board is reported in 41 B. T. A. 857, and the opinion of the Court below is reported in 119 Fed. (2d) 49.

II.
STATEMENT OF THE CASE

A statement of the case containing all that is material to the consideration of the questions presented with appropriate page references to the printed record has been made in the petition for the writ and such statement is hereby adopted and made a part of this brief.

III.
ASSIGNMENT OF ERRORS

The petitioner makes the following assignment of errors committed in the opinion and decision of the Court below:

1. The Circuit Court of Appeals erred in holding that Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases constituted that form of a restricted general partnership known as a joint venture.

2. The Circuit Court of Appeals erred in not holding that Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases constituted a mining partnership.

3. The Circuit Court of Appeals erred in not holding that Gant, Garvin and Wegener at all times owned as individuals an undivided one-third interest each in their Rusk County, Texas, oil and gas leases and that the use only of those leases was contributed to the joint enterprise

of their development in the name of Gant, Garvin and Wegener, whether such enterprise was a joint venture or a mining partnership.

4. The Circuit Court of Appeals erred in holding that the Rusk County, Texas, oil and gas leases were capital assets of Gant, Garvin and Wegener as a joint venture and business unit and legal person apart from and independent of the natural persons composing it, and that Wegener drilled wells on its leases under agreement with it as an independent opposite contracting party and not for himself as to his one-third interest in the wells and leases and for Gant and Garvin as to their two-thirds interest therein.

5. The Circuit Court of Appeals erred in holding that petitioner drilled wells for Gant, Garvin and Wegener as a business unit and independent opposite contracting party just as any outsider might have done with that organization and that all of the cash payment at the agreed price for drilling the wells received by him in excess of his actual cost in drilling them was a net profit, as though he had no interest in that organization had dealt with it as if it were a natural person or a corporation.

6. The Circuit Court of Appeals erred in not holding that one third of the amount the petitioner received from the joint account of Gant, Garvin and Wegener in excess of his cost in drilling the wells was in fact a payment made to himself out of cash paid by him as capital into said joint account, and that it was not a new acquisition or profit or gain to him.

7. The Circuit Court of Appeals erred in not holding that the sum of $130,594.50 paid to Wegener out of the money borrowed by him and Gant and Garvin and paid into their joint account was a distribution to the three of them in equal parts of paid in capital of their joint enterprise.

8. The Circuit Court of Appeals erred in not holding that the $23,592.08 received by Wegener out of the joint account of Gant, Garvin and Wegener in excess of one third of the cost of drilling the wells was his capital assets and that the imposition of income tax upon it was the taxation of capital and that, because he was required to pay income tax on his share of the oil runs from the oil properties which repaid the money he had borrowed and paid into the joint account, a tax on that sum was a double taxation of it.

9. The Circuit Court of Appeals erred in not holding that the said sum of $23,592.08 was not includable in the income of the petitioner for income tax purposes and in not reversing the decision of the Board accordingly.

IV.
ARGUMENT

Synopsis of Argument

In support of the errors assigned the petitioner asserts and relies on the following propositions which will be presented and considered in order:

1. In Texas an oil and gas leasehold is an interest in the fee title to land and is real estate.

2. Gant, Garvin and Wegener owned their Rusk County, Texas, oil and gas leases as tenants in common, each owning an undivided one-third interest therein.

3. The joint operations of Gant, Garvin and Wegener in developing and operating the oil and gas leases which they owned as tenants in common constituted them a mining partnership.

4. An oil well is a permanent improvement upon and becomes a part of the land on which it is located and the cost of it is a capital investment of the owner in his land.

5. Assuming, contrary to the fact, that Gant, Garvin and Wegener were co-adventurers in a joint venture, and that their leases were not owned by them individually but were joint venture assets, still the $130,594.50 paid Wegener for drilling wells was paid out of capital assets of the joint venture paid in in cash by its members, and of which petitioner had paid in one third, and no part of his share in this paid in capital was gain or profit when repaid to him.

6. The character of an organization is not determined or affected by the name applied to it and bookkeeping methods and entries are not controlling as to the facts.

7. Section 801(a)(3) of the Revenue Act of 1934 merely defines the business organizations required to file an informational income tax return on a partnership form and does not convert every such organization into a legally constituted general partnership in respect of the relationship of the organization to its members and of the members to each other.

Proposition One

In Texas an oil and gas leasehold is an interest in the fee title to land and is real estate.

It is settled law in Texas by an unbroken line of decisions of its courts that an oil and gas lease conveys title to the oil and gas in place to the lessee and an interest in the fee title to the real estate and that such a leasehold is real property.

Cases which so hold are:

Stephens County v. *Mid-Kansas Oil & Gas Company*, 113 Texas 160, 254 S. W. 290.

Sibley v. *Pickens* (Tex. Civ. App.), 273 S. W. 897.

Stephens v. *Stephens* (Tex. Civ. App.), 292 S. W. 290, 294.

Dunn v. *Tennant* (Tex. Civ. App.), 82 S. W. (2d) 728.

The rule stated has been recognized and applied in the following cases involving the income tax laws of the United States:

Ferguson v. *Commissioner* (5th C. C. A.), 45 Fed. (2d) 573.

Chesson v. *Commissioner* (5th C. C. A.), 57 Fed. (2d) 420.

Hammonds v. *Commissioner* (10th C. C. A.), 106 Fed. (2d) 420.

In *Hammonds* v. *Commissioner*, *supra*, the Court said:

"Under the law of Texas oil and gas in place are part

of the realty and an oil and gas lease transfers to the lessee an interest in real estate."

Proposition Two

Gant, Garvin and Wegener owned their Rusk County, Texas, oil and gas leaseholds as tenants in common, each owning an undivided one-third interest therein.

The leaseholds involved were assigned by the Reliance Oil & Royalty Corporation and others to Walter H. Gant and Knox L. Garvin (R. 98). They assigned to Wegener as sole assignee in a separate instrument specifically *an undivided one-third interest in them.* In six different places this assignment recites that it conveys an undivided one-third interest, and further states that Wegener takes such undivided one-third interest charged with all the duties, obligations and liabilities imposed upon and assumed by Gant and Garvin in the assignment to them (R. 84, 85, 87, 88). It is elementary that where a conveyance of an undivided interest in real estate is made to one grantee, he can take such interest only as tenant in common with the other owners of that real estate. There is no other relationship possible between him and them.

In *Earp* v. *Mid-Continent Petroleum Corp.*, 167 Okla. 86, 27 Pac. (2d) 853, it is said:

> "The owners of undivided interests in the oil and gas rights in and under real estate are tenants in common."

And this is the law in Texas. *Peterson* v. *Fowler*, 73 Tex. 524, 11 S. W. 534; 11 Tex. Jur. 422, Sec. 14.

Proposition Three

The joint operations of Gant, Garvin and Wegener in developing and operating the oil and gas leaseholds which they owned as tenants in common constituted them a mining partnership.

The Board found as a fact that Gant, Garvin and Wegener did not agree or intend to form and did not form a partnership, and the Court below accepted this finding. The term "partnership" as thus used has reference to a general commercial or trading partnership. It is elementary that such a partnership cannot be formed without an agreement to form it, express or implied, by all its members. It never results by operation of law without such agreement. The evidence in this case is conclusive that Gant, Garvin and Wegener never agreed, expressly or by any implication, to form a general partnership or any kind of a partnership, but that, on the contrary, they expressly disavowed any such purpose, intention or agreement. So the finding that those men never formed a general partnership is correct.

Yet the Board and the Court below held as a conclusion of law that Gant, Garvin and Wegener were joint adventurers in the development and operation of the oil and gas leases which they owned as tenants in common and that their co-operation in that enterprise was a joint venture. But a joint venture is a species of partnership and has all the legal characteristics of a general partnership except that it is confined to the conduct of a single transaction or a single specific business undertaking. It can be formed for carrying out any single transaction or busi-

ness undertaking that may be carried on by a general partnership. *Like a general partnership, it can be formed only by agreement of its members and never results purely by operation of law without such agreement.*

In 15 R. C. L. 500, it is said:

> "A joint adventure generally relates to a single transaction. The usual test of a partnership as between the parties to a joint adventure is their intent to become partners."

In 33 C. J. 859, para. 59, it is said:

> "The members of a joint adventure have the power and interest of partners as to the disposition of the property involved in the enterprise, and, if the power to sell is not limited by the contract between or amongst them, a sale made by either or any member in good faith binds both or all of them."

There are literally scores of judicial definitions of a joint venture and while there are some variations in these in different jurisdictions, they are substantially in harmony. It would serve no useful purpose to present a great array of them. They are collected and cited in 4 Words & Phrases (1st Series) at pages 3814 *et seq.*; in 2 Words & Phrases (2nd Series) at pages 1232 *et seq.;* in 4 Words & Phrases (3rd Series) at pages 587 *et seq.;* and in 2 Words & Phrases (4th Series) at pages 464 *et seq.*

In *First Mechanics Bank* v. *Commissioner* (3rd C. C. A.), 91 Fed. (2d) 275, the Court said:

> "The concept of a partnership has been long established in the Common Law. Joint venture, as a legal concept, however, is of comparatively recent origin,

33 Corpus Juris, 841. It has been defined as a 'limited partnership; not limited in a statutory sense as to liability, but as to its scope and duration.' 4 Words & Phrases (1st Series), 3814. The relationship of a joint venture may exist where persons embark in an undertaking without entering upon the prosecution of the business as strict partners, but engage in a common enterprise for their mutual benefit. Each has the right to demand and expect from their associates good faith in all that relates to their common interests. * * *

"*Whether or not the parties to a particular contract have, as between themselves, created the relationship of a joint venture depends upon their intention.* 33 Corpus Juris, 845, Section 16; *Reid* v. *Schaffer*, 249 Fed. 553 (C. C. A. 6)."

There is no need to present more authorities to the same effect. *It is established that a joint venture, like a general partnership, is created only by intention and agreement of the parties and that, as to the specific transaction or undertaking which is the subject of the venture, the relation between the members themselves and between the members and third persons is precisely that of general partners.* This last is just what Gant and Garvin and Wegener did not want and did not intend and agreed they would not have.

The petitioner contends that in combining to develop and operate their oil and gas leases Gant, Garvin and Wegener by operation of law constituted themselves a *mining partnership*, and that the holding of the Board and the Court below *that they were a joint venture is contrary to the evidence and contrary to the law.*

A mining partnership has many features in common with a general partnership and a joint venture, but it has certain characteristics wholly distinct from and at variance with both. Some of its peculiar characteristics are:

(1) That it can exist only in the development and operation of a mineral property;

(2) That it results without agreement, by operation of law from the action of the parties in jointly developing their separately owned interests in the mineral property;

(3) That, considered as a business unit, it never owns the mineral property, but the members continue to own their several interests in it in their individual capacities as tenants in common;

(4) That a member may at any time sell and convey his interest in the mineral property without the consent of the others and such sale does not dissolve the partnership, nor does the death of a member dissolve it, but the purchaser or the personal representative or heir of a deceased member, by operation of law and without the consent of the others, becomes a member in the place of the seller or of the deceased member, as the case may be.

(5) That a member cannot sell, convey or encumber any interest in the mineral property other than his own.

(6) That if a member sells his interest in the mineral property, any profit or loss on the sale is his individually and other members do not participate therein.

The undisputed facts are that Gant, Garvin and Wegener were owners as tenants in common of equal undivided interests in these oil and gas leases; that they developed and operated them jointly and in co-operation as equal owners; that they never *agreed to be partners or joint adventurers in that undertaking and to have as to each other and to third persons the rights and obligations of partners in respect of that particular enterprise, which agreement was necessary to constitute them either a partnership or a joint venture; that on the contrary, they expressly agreed that they would not have the relationship of partners, even though limited to the particular enterprise of developing and operating those leases; but that they did agree to and did jointly work and operate their common mineral property for their common good.* These facts constituted them in law a mining partnership. This is the relationship between them that would exist under the law generally and that did exist under the law of Texas where the property was located and their business was carried on.

In 15 Am. & Eng. Ency. of Law 609, a mining partnership is defined as follows:

> "Where tenants in common of a mine unite and cooperate in working it, they constitute a mining partnership."

In 18 R. C. L. 1200, it is said:

> "Where the several owners of a mine unite in working it, they form what is termed a mining partnership, whether they are tenants in common, lessees, or owners in any other relation. * * * While a mining part-

nership may be created by the express contract of the parties, it may be inferred also from their acts; *it being necessary only—and this is essential—that the co-owners of the property unite in operating or working the mine.*"

In Thornton on the Law of Oil & Gas (4th ed.), Vol. 1, page 894, para. 355, it is said:

"If two or more owners of a mine unite in working it, without any partnership agreement, the act of working it together creates a mining partnership; and the same is true of two or more holding interests in a lease of mining property. * * * They form what is termed a mining partnership * * * but which has also some rules peculiar to itself, one of which is that one person may convey his interest in a mine and mining business without dissolving the partnership."

And on page 897, paragraph 357, of the same text, it is said:

"But where tenants in common co-operate in developing a lease for oil and gas, each agreeing to pay his part of the expense and to share in the profits on the leases, they constitute a 'mining partnership.' "

In Mills & Willingham on the Law of Oil & Gas, page 274, it is said:

"A mining partnership is not based upon any agreement, either express or implied, but arises from the relation of the parties independent of a purpose to form a partnership, and in spite of an express intention to the contrary, when two or more co-tenants unite and operate in the development and operation of a mine or a mining claim."

In 29 Tex. Jur. 698, para. 32, it is said:

> "Mining partnerships are recognized in Texas. To constitute such a partnership there must be not only a joint ownership of mining property, but also joint operation thereof; the relation is not created merely by sharing in the net profits of an enterprise. However, an express agreement between the partners is unnecessary; 'the rule is that a mining partnership arises by operation of law where co-owners work a mine.' "

In *Munsey* v. *Mills & Garritty*, 115 Tex. 469, 283 S. W. 754, there is an elaborate consideration of the law of mining partnerships and its application to the joint development of oil and gas properties in Texas. It is needless to quote at length from this case, because it is not only the leading case on the subject in Texas, but a leading case on the subject in all jurisdictions, and this Court will examine it. The holding of the case on the point here involved is stated in the syllabus as follows:

> "Where joint owners of an oil lease unite in operating the premises without any special agreement as to their relation, they constitute a mining partnership."

See also:

Wagner Supply Co. v. *Bateman*, 118 Tex. 498, 18 S. W. (2d) 1052.

Shell Petroleum Corp. v. *Caudle* (5th C. C. A.), 63 Fed. (2d) 296.

Childers v. *Neely*, 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468.

Barrett v. *Buchanan*, 95 Okla. 262, 213 Pac. 734.

McKay v. *Kelly*, 130 Okla. 62, 264 Pac. 814.

The undisputed facts and the uniform rule of law, and particularly the law of Texas which is controlling here, conclusively establish that Gant, Garvin and Wegener were not a joint venture, but were a mining partnership, in the development of their oil and gas leases.

The peculiar features of a mining partnership are stated in 18 R. C. L. 1201 as follows:

> "A mining partnership is governed by many of the rules relating to ordinary partnerships, but it has some rules peculiar to itself. The principal distinction between it and an ordinary partnership is that in a mining partnership the *delectus personae*, or the right of a partner to say whether a new partner shall be admitted to the partnership, is absent. Another distinction is that the law does not imply any authority, either to a member of such partnership, or to its managing agent, to bind the individual members upon any evidence of indebtedness. A third distinction is that, whereas a sale by a partner in an ordinary partnership dissolves it and compels a winding up and settlement of the business, in a mining partnership such a sale does not effect its dissolution but it continues with the owners as newly constituted. Because of these features mining partnerships have been said not to be true partnerships, but rather a cross between tenancies in common and partnerships proper. From these principles it is clear that a member of a mining partnership may sell his interest therein to whomsoever he may without the knowledge or consent of his co-owners; and that thereby a new member is brought into the partnership without the consent of his associates; and may purchase interests in it or in other mines for his own benefit without being required to account to the partnership for the property. From this

it is obvious that no relation of trust and confidence is created by a mining partnership in respect to the individual interests of partners therein, provided, of course, there is no express contract that the purchase should be for the benefit of all. But one member of a mining partnership cannot, without the consent of his co-partners, convey any other interest in the mine than his own."

See also:

Thornton on the Law of Oil & Gas (4th ed.), Vol. 1, 889 *et seq.*

Mills on Oil & Gas (1926 ed.), 273 *et seq.*

Skillman v. *Lachman*, 23 Cal. 198.

Childers v. *Neely*, 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468.

Kahn v. *Central Smelting Co.*, 12 Otto (102 U. S.), 641, 645.

Bissell v. *Foss*, 114 U. S. 252, 29 L. ed. 126, 5 Sup. Ct. 851.

Harris v. *Lloyd*, 11 Mont. 390, 28 Pac. 736.

In a mining partnership the mineral property is not owned by and is not assets of the partnership as a business unit, but the members own their respective interests in it in their separate and individual capacities.

In 29 Tex. Jur. 698, Sec. 32, it is said:

"Under a mining partnership, the mine is owned by the partners as tenants in common, and each is jointly and severally liable upon obligations incident to the development enterprise. Contrary to the rule prevailing in the case of trading partnerships, a mining copartner may sell his share to a third person without the consent

of his co-owners and without dissolving the partnership. Also, the 'estate' of a mining partner succeeds to his interest upon his death, and has the same relation to the other partners as would the deceased were he alive."

In *Adams* v. *Texhoma Oil & Refining Co.* (Tex. Civ. App.), 262 S. W. 139, 141, the Court says:

"As a general rule in mining partnerships the co-owners of the mine are partners only in the profits; the mine itself being owned by them as tenants in common rather than as partners."

Finally in *Munsey* v. *Mills & Garitty, supra*, the following statements, each supported by an array of authorities, are approved by the Court:

"In a mining partnership the mine is owned by the partners as tenants in common.

"But the individual interests of the partners in the mineral estate are not partnership assets.

"In a mining partnership, the ownership of the mine as cotenants allows one partner to sell his share to a third person without the consent of his copartner and without dissolving the partnership, since the profits follow the property."

So in the mining partnership of Gant, Garvin and Wegener each member individually and in his private right, owned an undivided one-third interest in the oil and gas leases which he had the right and power to sell and convey by title in fee simple absolute, without the knowledge or consent of the other members of that mining partnership and without disrupting the partnership.

It follows necessarily that the partnership as a business

unit never owned those oil and gas leases and never had any capital investment in them. Its function was to develop and operate jointly the separately-owned interests of the members in the mineral property, and its capital as such consisted only in the money and personal property paid in by the members for the purpose of enabling it to perform that function.

In Mills on Oil & Gas (1926 Ed.), 277, para. 186, it is said:

> "In a mining partnership the lease or mineral right is owned in common by the joint tenants and not by the partnership; accordingly, *the only social assets are the machinery and equipment used in operating it, the moneys received by the sale of the joint product, and the property bought with the common funds.*"

In the same text at page 280, para. 188, after stating that in a mining partnership the majority of members and interests control the business of the partnership, it is said:

> "But such control and management extends only to the social assets of the partnership. The interests in the lease itself, or in the mine, being the property of the cotenants and not of the partnership, the majority have no right to sell or dispose of any of the interest of any of the cotenants in such lease or mine."

Numerous cases are cited in support of the foregoing texts.

See also:

Thornton on the Law of Oil & Gas (3rd Ed.), Vol. 1, p. 528, para. 362.

Childers v. *Neely,* 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468, 81 Am. State 777.

Blackmarr v. *Williamson*, 57 W. Va. 249, 50 S. E. 254.

Dougherty v. *Creary*, 30 Cal. 290, 89 Am. Dec. 116.

Hawkins v. *Spokane, etc., Co.*, 2 Idaho 970, 28 Pac. 433.

Edinger v. *Southern Oil Co.*, 69 W. Va. 34, 71 S. E. 266.

Doyle v. *Burns*, 123 Iowa 488, 99 N. W. 195.

It is established that in a mining partnership in the absence of some special agreement, not a necessary feature nor legal attribute of such partnership, the mineral property does not belong to and is not capital assets of the partnership as a business unit, but remains the separate and individual property of the members, and, therefore, the only capital investment and capital assets of a mining partnership are money contributed for the working of the mine and personal property acquired for that purpose.

Proposition Four

An oil well is a permanent improvement upon and becomes a part of the land on which it is located and the cost of it is a capital investment of the owner in his land.

The correctness of this propostion would seem self-evident. An oil well, like a building, a water well, a reservoir, landscaping and terracing or any other structure made for bettering and increasing the usable value or the market value of real estate, is a permanent improvement of such real estate. The cost of it is ordinarily a capital investment

in the property and not deductible as ordinary and necessary business expense in determining income tax liability.

Section 24(a)(2) of the Revenue Act of 1934, being the Act applicable to the year involved in this case, reads as follows:

> "Section 24(a) General Rule: In computing net income no deduction shall in any case be allowed in respect of—
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> * * * * * * *
>
> "(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

This provision has appeared in identical language in practically all the Revenue Acts. The regulation on it under the 1934 Act is Article 23-2 of Regulations 86.

Whatever may be said with respect to a dry hole, it cannot be seriously argued that a producing oil well is not a permanent improvement or betterment made to increase the value of the property and estate on which located. This fact is fully recognized in all decisions on the subject.

We do not overlook the Treasury Regulation, Article 23(m)-16 of Regulations 86, which gives a taxpayer an option to elect in the first instance whether he will capitalize the intangible costs of drilling a hole for oil or will deduct those costs as ordinary and necessary business expense. But whether the intangible cost of the wells here involved, regardless of their ownership, has been expensed or capitalized is immaterial, for that question relates merely to the

owner's cost in the wells and does not change their character as permanent improvements on the land and capital assets to the owner.

The Board of Tax Appeals has uniformly held that the expense of drilling an oil well or a water well is a capital expenditure:

Consolidated Mutual Oil Co., 2 B. T. A. 1067.

Old Farmers Oil Co., 12 B. T. A. 203.

George W. Wetherbee, 20 B. T. A. 35.

Sunburst Oil & Ref. Co., 23 B. T. A. 829.

Monrovia Oil Co., 28 B. T. A. 335.

Phillip Diet, 7 B. T. A. 1948.

Now if an oil well is a permanent improvement upon and becomes a part of the land on which it is located, it belongs to the owner of that land, whether he has any cost or capital investment in it for income tax purposes or not. And the owners of the land on which a well is located own the well in the same interests and proportions as they own the land and the cost of it is a capital investment of each of them to the extent of the cost thereof paid by each. It follows that the amount paid for oil wells by each member of the joint enterprise of Gant, Garvin and Wegener out of their borrowed money was additional capital investment of each in his undivided interest in the leases and in those wells, and if this money had ever been a part of his capital investment in his interest in the partnership, it was by its application in payment on his separately-owned interest in the wells withdrawn from the partnership capital and distributed to him. But since it was a distribution from capital and not

from profits of the partnership, no part could be gain to the member receiving it.

Proposition Five

Assuming, contrary to the fact, that Gant, Garvin and Wegener were co-adventurers in a joint venture, and that their leases were not owned by them individually but were joint venture assets, still the $130,594.50 paid Wegener for drilling wells was paid out of capital assets of the joint venture paid in in cash by its members, and of which petitioner had paid in one third, and no part of his share in this paid in capital was gain or profit when repaid to him.

Obviously the mere return of all or part of the capital which the owner has paid into a depository or a fund or an enterprise cannot constitute gain or profit. Here Wegener's borrowed money was capital paid by him into the joint account of Gant, Garvin and Wegener and when he was paid out of that joint account for drilling the wells, he received back the distribution of a part of the very capital he had paid into it. There can no more be profit or gain to him in that transaction than there would be if he had placed his borrowed money on deposit in bank to his credit or in currency in his safety deposit box and thereafter had checked out part of his deposit or had abstracted part of the currency from his box. The Internal Revenue Acts impose a tax on income only. They do not, and properly cannot under constitutional provision, tax capital. In all the changing forms of investment a taxpayer has a right to the return of his capital tax free.

Where a taxpayer pays capital into a business enter-

prise, whether a joint venture or a mining partnership, and then, as compensation for services or for merchandise or other property, receives payment out of the capital which he has paid into the enterprise, he realizes no gain in the transaction, for the money paid to him is merely a return of his capital investment. If the payment to him was for services or for merchandise or property sold at a price above his cost therein, he would have a profit or gain to the extent that his services were paid for, or that his margin of sale price above cost was paid, out of the shares of other members in the capital assets of the organization. Of course, under such circumstances any payment made to him out of earnings of the organization would include profit and gain to the same extent, and to be determined in the same manner, as if he had dealt with an individual or corporation as the opposite party. But insofar as such payments result in the reduction of his capital investment in the partnership, they are not income or gain to him. This for the reason that he has merely transferred part of his capital investment out of a joint ownership with his partners into his individual ownership—has merely transferred money from one to another of his own pockets.

In G. C. M. 6582, C. B. VIII-2, 200, it is said:

> "To the extent that the excess amount withdrawn by a partner represents his personal capital investment it is capital investment of the partner and not taxable income, but to the extent that the excess amount withdrawn is chargeable to the other partner's capital account, it is taxable income to the partner receiving it although deductible by the partner from whose capital investment it is taken."

In *S. U. Tilton*, 8 B. T. A. 914, 917, it is said:

"A partner receiving a salary is merely transferring money from one to another of his own pockets.

* * * * * * *

"To hold that a salary paid by a partnership to one of its members *is income when received, regardless of whether such payment is made from capital or profits, may result in the taxation of capital.*"

To the same effect are:

Leo Schwartz, 7 B. T. A. 223.

Augustine M. Lloyd, 15 B. T. A. 82.

Melville W. Thompson, 18 B. T. A. 1192.

United States v. *Coulby* (D. C., N. D., Ohio), 251 Fed. 982.

United States v. *Coulby* (6th C. C. A.), 258 Fed. 27.

A partnership is not a taxable person or a legal entity for income tax purposes. Section 181 of the Revenue Act of 1932 and Section 181 of the Revenue Act of 1934 are identical in the following language:

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacities."

A partnership is merely a group of persons associated together for the transaction of business and as such is merely the agency, means or medium through which each member of the group individually transacts business and realizes individual gain and profit or sustains individual loss. This purpose of the group association of individuals is more

pronounced in a mining partnership than in a general partnership or a joint venture, for the members of a mining partnership retain separate and individual ownership of their respective interests in the mineral property which never becomes assets of the partnership, but of which the use only is contributed to the partnership. The only thing its members have in common is the money and personal property which they contribute to their group association for the purpose of jointly developing and operating their separately-owned interests in the mineral property. Yet with respect to income taxation every form of partnership is regarded as merely a group of persons associated together for the transaction of a business in which they own individual interests. Partnership income is not to be computed on an entity basis and the partnership treated as an independent business unit for the purposes of income taxation. True, returns called partnership returns are required of every kind of group of persons associated together in carrying on a business. But these are informational returns and their purpose is to enable the ascertainment of the amount of gain realized or loss sustained by each individual on account of his interest in the business operations of the group. This is established by the following authorities:

United States v. *Coulby* (D. C., N. D., Ohio), 251 Fed. 982.

United States v. *Coulby* (6th C. C. A.), 258 Fed. 27.

Craik v. *United States* (Ct. Cl.), 31 Fed. Supp. 132.

Carroll v. *Commissioner* (5th C. C. A.), 70 Fed. (2d) 806, 808.

Jennings v. *Commissioner* (5th C. C. A.), 110 Fed. (2d) 945.

Neuberger v. *Commissioner,* dec. Sup. Ct. U. S., Nov. 12, 1940, not yet off. rep., 61 Sup. Ct. 97.

Proposition Six

The character of an organization is not determined or affected by the name applied to it, and bookkeeping methods and entries are not controlling as to the facts.

In its opinion the court below said:

> "For reasons best known to themselves they chose to carry on their operations as a joint venture in the name of Gant, Garvin & Wegener with a joint banking account and a separate bookkeeping system. This method of doing business cannot at this late date be repudiated solely to avoid taxation" (R. 144).

We have elsewhere shown that "their operations" were as a matter of fact and law carried on as a mining partnership. It is true that in various instruments introduced in evidence their joint operations are sometimes named a partnership and sometimes a joint venture and the members are sometimes referred to as partners. But the name applied to their joint operations is neither controlling nor important in determining its correct legal nature. Their organization is such as the facts of what they agreed upon and what they did make it, and not what they may have called it.

In *Beecher* v. *Rusk,* 45 Mich. 188, 194, 7 N. W. 785, 40 Am. Rep. 465, Judge COOLEY quotes with approval from

Chancellor KENT in *Post* v. *Kimberly*, 9 Johns. (N. Y.) 470, 504, as follows:

> "The law must declare what is the legal import of their agreements, and names go for nothing when the substance of the arrangement shows them to be inapplicable."

And in literature as well as in law, it has been recognized, at least since Skakespeare's time, that names do not control or change substance. Witness the immortal words of Juliet in Scene II, Act II, Romeo and Juliet:

> "What's in a name? That which we call a rose,
> "By any other name would smell as sweet."

The petitioner never has repudiated his "method of doing business," and never has desired, and does not now desire, to do so, if he could. The method first used in 1932 was, as a matter of convenience, changed slightly in form, but not in effect, in September of that year. As thus changed it was accepted by the Bureau of Internal Revenue for the years 1932, 1933 and 1934 as correctly reflecting the expenditures upon and income from his separately-owned and jointly-operated one-third interest in the Rusk County, Texas, leases. In 1935 the Bureau repudiated its position in the three previous years and for the first time asserted that petitioner was making a profit in drilling wells for himself as well as in drilling wells for Gant and Garvin.

It is not disputed that the bookkeeping method of charging the full amount of the agreed footage price for drilling the wells to an account entitled "Gant, Garvin & Wegener" and then crediting a separate account called "Lease Investment Contra" with one third of the profit in

that price correctly reflected the facts and that petitioner's books thus kept showed that he did not realize a profit on his one third of the price of the wells. This is all that any bookkeeping method and any bookkeeping entries needed to show, for they do not create nor control facts. Their purpose is to record facts and furnish a source of information. They are at most evidential and are to be interpreted in the light of known facts and are overcome by facts otherwise established.

In the case of *In re Sheinman* (D. C., E. D., Pa.), 14 Fed. (2d) 323, the Court says:

> "The ascertainment of the amount of the net taxable income of the taxpayer is the ascertainment of a fact. Real facts and not bookkeeping entries give rise to income. Books of account are no more than evidential. They are neither indispensable nor conclusive. [Citing cases.]
>
> * * * * * * * * *
>
> "The decisions under the excise tax law and under the income tax law are uniform to the effect that the Government cannot base a claim for taxes on mere bookkeeping. [Citing cases.]"

In *Southern Pacific R. Co.* v. *Muenter* (9th C. C. A.), 260 Fed. 837, 838, the Court said:

> "A system of bookkeeping will not justify the Government in claiming taxes, nor would it justify the taxpayer in claiming exemption from taxation. The facts must control. [Citing cases.]"

In *Douglass* v. *Edwards* (2d C. C. A.), 298 Fed. 229, 234, the Court said:

"There is no question of good faith in regard to these entries; but it is well at the outset to realize that, in this case, the rights of the parties can neither be established nor impaired by the bookkeeping methods employed, or by the names given to the various items."

In *Doyle* v. *Mitchell Bros.*, 247 U. S. 179, the Court, commenting on book entries involved in that case, said:

"Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case, are not in dispute."

Proposition Seven

Section 801(a)(3) of the Revenue Act of 1934 merely defines the business organizations required to file an informational income tax return on a partnership form and does not convert every such organization into a legally constituted general partnership in respect of the relationship of the organization to its members and of the members to each other.

Section 801(a)(3) of the Revenue Act of 1934 reads as follows:

"SEC. 801. DEFINITIONS.

"(a) When used in this Act—

* * * * * * *

"(3) The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term 'partner' includes

a member in such a syndicate, group, pool, joint venture, or organization."

Supplement F of that Act deals with partnerships and comprises sections 181 to 188. Section 181 provides that:

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

It seems plain that the purpose of Section 801(a)(3) was merely to require each form of business organization defined therein to file a partnership informational return disclosing the net profit or loss to each member from the business he carried on through such organization.

It is not conceivable that Congress intended to break down all distinctions in respect of capital investments, property rights and ownership, and the legal relationship between the organization and its members and between the members themselves that exist between the designated organizations and a general partnership, and convert each of them into a general partnership and impose upon it and its members all the rules of law applicable to a general partnership and determine the net profits or losses to its members in all respects as though it were a general partnership. *United States* v. *Coulby* (D. C.), *United States* v. *Coulby* (6th C. C. A.), *Craik* v. *United States, Carroll* v. *Commissioner, Jennings* v. *Commissioner, Neuberger* v. *Commissioner, supra.*

Both the Board and the Court assert that the so-called joint venture capitalized the amount paid Wegener for drilling the wells as cost in its capital assets consisting of

the wells. *There is no fact foundation for this assertion.* The Board says:

> "It is true that the joint venture had a right to elect to treat 'intangible' development costs as ordinary and necessary expenditures in its income tax return, Regulations 86, art. 23(m)-16, but it did not do this. Obviously it elected to capitalize the entire development cost, and we see no reason for treating it otherwise" (R. 33).

The Court said:

> "Furthermore, the cost of drilling wells was capitalized, and Wegener and his associates will recover this cost by way of depletion as oil is produced from the lease" (R. 144).

The only basis for the foregoing is the fact in respect of the partnership form returns stated both by the Board (R. 29) and the Court (R. 142) in identical language as follows:

> "No deduction was taken on these returns for the cost of drilling oil wells, or for any amount paid out for such drilling."

The position of petitioner and his associates was that the joint enterprise as a separate business unit never owned the oil and gas leases and never paid for drilling wells on those leases and never owned the wells after they were drilled, but that the leases and the wells at all times belonged to the three of them as co-owners in undivided one-third interests. On this theory it would have been improper and incorrect for any deduction for the cost of drilling wells to have been taken as expense on the returns

filed on a partnership form. The fact is that no deduction for intangible drilling costs was taken on the partnership form of return, not because such costs were treated as capitalized cost of partnership wells, but because the wells were not partnership wells and the drilling of them was not partnership expense and hence *such expense could not be deducted on the partnership form of return.*

The cost of these wells was the expense of the three individuals who owned them as tenants in common and, whether expensed or capitalized, was for them to determine on their respective individual returns. So far as the so-called joint venture was concerned, it merely distributed to its members $130,594.50 of their paid in capital.

It does not appear from anything in the record, and is not material here, whether Wegener capitalized or expensed the intangible drilling costs of an undivided one-third interest in the wells. If he did capitalize it, the only amount of allowable cost therein would be what he *actually paid for drilling a one-third interest in them* and would not include the fictitious profit of $23,592.08 which he never spent on them.

Let us assume that in 1935 Wegener alone owned an oil and gas leasehold which he desired to develop. He estimated that it would cost $75,000 to drill the wells he wanted and borrowed that sum from a bank to cover such estimated cost. Within the year he drilled the wells, but they cost only $50,000. No one, not even the Commissioner or anyone connected with his office, would have the hardihood to say that the unused $25,000 of borrowed money was

profit to him; that he was required to include it in income on his return and pay tax on it; and that then he might add it to the $50,000 as capital invested in the wells and expect to get it back tax-free through depletion allowances. How could it be cost or capital investment in the wells when not a cent of it was spent on them?

Yet in the instant case, the Commissioner, the Board and the Court below have said what amounts to the same thing on a slightly varied, but not substantially different, state of facts. The sole and only factual difference between the supposed case and this one is that here Wegener, instead of owning an entire leasehold, owned an undivided one-third interest in it, and that instead of borrowing the money to develop it alone, he joined with the owners of the two-thirds interest in borrowing the money, and when the wells were drilled he had spent less than his one third of the money borrowed for drilling them, because he had saved cost by doing the work himself, although the other owners had spent all of their two thirds of the borrowed money, because they hired their two thirds of the work done. How can the borrowed money that he saved on his share of the cost of the wells by doing the work himself be profit and taxable gain to him and cost or capital investment in the wells?

The Board and the Court below have avoided the obvious answer to this question by saying that the three owners of the leasehold constituted a species of partnership called a joint venture and that this was a legal entity or a business unit or a thing apart from its members, and as

such owned the leaseholds and contracted for drilling its own wells on them and paid for these wells out of its own funds without regard to the source of those funds.

This violates the most fundamental and distinguishing characteristic of a mining partnership and is in fact in complete disregard of the fundamental legal concept of a general partnership or of a joint venture.

The Court below distinguishes its decision in *Ortiz Oil Company* v. *Commissioner* (5th C. C. A.), 102 Fed. (2d) 508, from the instant case (R. 144). There the owner of a half interest in a lease drilled a well under an agreed price therefor with the other owners. They paid him their one half of this agreed price and it was held that the excess of the amount so paid over one half his cost in the well was income and profit, but that he did not realize a profit on the drilling of his half of the well measured by the difference between half his actual cost and half the agreed price. The Court below says that that case applies to the arrangement between Wegener and Gant and Garvin for the year 1932. So if Wegener had drilled the wells and paid the entire cost thereof out of his personal funds and then collected from Gant and Garvin the difference between the agreed price and two thirds of the cost, he would not have been charged with a profit on his one-third interest in the wells measured by the difference between one third of the cost and one third of the agreed price. But the Court says that a new method was adopted after 1932 and that this changed entirely the position of Wegener in respect of the drilling of the wells. The only change was that

instead of the accounts of the individuals being handled separately and the payments each was obligated to make being made separately, they combined them in a joint account of which each paid in one third, and then each paid his part of the cost out of that joint account. Wegener paid himself for his one third of the wells out of his one-third interest in this joint account. To say that he realized a profit on the amount he thus paid himself is to sacrifice substance for form. Taxable income is not created by methods of handling accounts or of keeping books, but arises only from the ultimate fact that a taxpayer has made a profit or gain—has acquired something he did not have before.

CONCLUSION

For his conclusion to this brief the petitioner adopts the following from the dissenting opinion of Judge HUTCHESON in the Court below:

> "Looked at realistically, that is, as the facts are, Gant, Garvin and Wegener represent merely a name and device through which petitioner and his associates conducted the business of drilling on and operating their properties. The substance of the matter at all times was that the properties were owned by the three as co-owners, the development was paid for by the three as co-owners, and the returns from the oil runs were paid individually to each of the three as co-owners. Under these facts, Wegener as to the $23,592.08 in question, was merely being repaid advances he had made to the joint venture and it would be a denial of everything that has been written and said in taxing statutes and decisions, relating to and affecting

partners and partnerships and their return and payment of income taxes, to treat this sum as income" (R. 150).

The petitioner asks that this Court grant the writ of certiorari as prayed for and review the decision of the Court below.

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